OCCASIONAL PAPERS
№ 2
(May 1999)

EPI Occasional Papers are prepared by experts working on economies of transition issues. The Papers are designed to contribute to the discussions or/and to provide information on specific topics. Any comments are welcome.

Non-banking Sources of Financing for Small and Medium-Size Enterprises*

Boris Landjev

The complicated economic situation in Bulgaria and the restrictive legal framework in the banking sector are among the main reasons for the "withdrawal" of Bulgarian banks from lending to the real sector. Even when banks tend to lend, they have too high requirements as to the collateral provided by the borrowers. Few borrowers could afford to meet such requirements. Practically there exist no cases, where banks would lend without serious real collateral, such as pledged government securities or other low-risk debt instruments, pledged movable property under the Special Pledges Act, which is easy to liquidate on the market at an expected price, if necessary, or pledged real estate for which functioning market and stable prices exist. Banks normally do not take the risk of lending only against a perfect business plan and optimistic economic projections for the development of the borrower. This line of conduct of banks is a substantial obstacle mainly to small and medium-size enterprises (SMEs) that usually are not in a position to provide the substantial collateral required by banks.

What is the way out of this unfavourable situation on the lending market? A possible solution is to seek sources of funding outside the banking system. For this purpose, an attempt could be made to attract "loan" or "investment" capital from other places.

"Loan capital" could be defined as the total of all resources that could be raised on the basis of a loan agreement or other similar legal instruments. Loan agreements are regulated in Title VI of the Special Part of the Obligations and Contracts Act. The regulation consists of two provisions only (Arts. 240 and 241), covering "private loans", i.e. generally transactions without any payment involved, which are concluded "accidentally" between ordinary individuals that have never engaged in business activities. Such agreements pursue purely consumer purposes and the subject-matter can be either cash or other cash equivalents.

Therefore it is fully justifiable to ask oneself whether the existing legal framework is sufficient to solve the existing problem with the sources of non-bank financing for undertakings that engage "professionally" in business. The loan agreements envisioned in the Obligations and Contracts Act could serve lending purposes to a certain extent. True, no payment is involved but there exist no obstacles to negotiating interest rates, in pursuance of the provisions of Art. 240, para 2 of the Obligations and Contracts Act, up to the level established by the Council of Ministers (up to ten percentage points over the base interest rate established by the Bulgarian National Bank as of the date of execution). The borrower can be any individual or legal entity, no matter whether the person is engaged in business activity or not, be it an incorporated company, foundation or not-for-profit organisation under the Persons and Family Act. Furthermore, there exist no obstacles on the basis of the loan agreement for the borrower to issue a promissory note to the lender within the meaning of Art. 535 of the Commercial Code for the whole amount borrowed plus the agreed interest as a further guarantee of the borrower's serious intentions. The advantage of the promissory note (and the bill of exchange, which is inapplicable to this case) is mainly the fact that, in accordance with the provisions of Art. 237, item "e" of the Civil Procedure Code, it has the legal effect of out-of-court execution grounds. This means that execution procedures may be undertaken with respect to the property of the debtor who has issued the promissory note immediately after default is observed at maturity, i.e. without the costly, slow and uncertain litigation otherwise required. The provision of such a guarantee by the debtor could more seriously motivate the lender to make a decision on the execution of a loan agreement.

While examining the general applicability of loan agreements as a possible legal instrument for borrowing local capital, we must point out the essential fact that the loan may not be effected within the framework of the own business of the lender, i.e. lending should not be done "by occupation", as this will be tantamount to circumvention of the Banks Act. In accordance with the Banks Act, only banks are entitled to lend, and any violation of this provision entails serious liability, including criminal liability. Therefore the borrowing of loan capital on the basis of a loan agreement concluded with an appropriate person prepared to fund a specific undertaking may be viewed only as an exception rather than as a generally accessible source of funds.

In the context of the above considerations, we have to note that, as well as banks, there is another category of persons who would be able to lend loan capital to undertakings without any legal problems on the basis of an explicit legal provisions, provided, of course, that they are prepared to assume the related risks. In this case, they can be considered to be potential sources of financing. These are the holding companies within the meaning of Art. 277 of the Commercial Code. In pursuance of the provisions of Art. 280, para 1 of the Commercial Code, holding companies may offer loans, but this opportunity is restricted only to their subsidiaries, in which the holding companies have direct equity interest or control ensured in another way. As a matter of fact, there are processes of development of economy of the holding type in Bulgaria. This type of economy is typical of all advanced countries and the world economy as a whole. Still, the overwhelming majority of SMEs operate as independent businesses and the big "players" on the market do not display any particular interest in them. Hence, the opportunity for using this source of finance relates only to undertakings that are incorporated in an existing holding structure rather than to independent legal entities.

Another possible way of attracting loan capital outside the banking system, except for the execution and implementation of loan agreements, is the "borrowing" of funds from the general public, i.e. the issuance of bonds. The big problem here is that only joint stock companies are entitled to issue bonds, while this legal form is hardly appropriate for the operation of SMEs in view of the minimum required capital of BGL 50 mn for the registration of joint-stock companies. Besides, bonds may be issued only through public offering. This implies the preparation of a prospectus under the terms and conditions laid down in the Securities, Stock Exchanges and Investment Companies Act (the Securities Act) and the secondary legislation thereof. The prospectus is subject to approval by the Securities and Stock Exchanges

Commission. The issuer has to pay the costs for the preparation of the prospectus, as well as other considerable costs. We can sum up that the public placement of bonds for the purposes of working capital borrowing can hardly be viewed as a realistic option for small and medium-size entrepreneurs.

There is a second option for use of borrowed resources, which stands considerable chance of success. In this case, the necessary capital is not borrowed in the form of a loan, where the lender is interested only in repayment at maturity. This option implies that capital is attracted in the form of investments, i.e. "joint venture", whereby the risks and responsibilities are shared between the beneficiary and the investor until the successful completion of the financed project. There exist more opportunities in this case. They could be applied flexibly to each specific case in view of the specific set-up, the capabilities of the parties and the existing risks. Generally, "investment" capital may be attracted in the following three forms:

- Public offering of stock;
- Execution of joint venture agreements with appropriate investors; and
- Involvement of equity participation without public offering.

The opportunity for additional financial resources to be raised by means of increase of capital through *public placement of stock* is as applicable in practice as the issuance of bonds. Here again, the main problem is that the undertaking has to be registered in the form of a joint-stock company, which is not the most appropriate form for the existence of SMEs. Since it is not applicable for the purposes of this study, we are not going to discuss this option, although it is very much relevant and applicable to commercial practices in developed countries.

Let us examine the options provided through *joint venture agreements* as a major form of attracting external capital for investment purposes in specific spheres of economic life. This type of agreement is called "partnership agreement" and it is regulated in Title XV of the Special Part of the Obligations and Contracts Act. The essence of the agreement, as laid down in Art. 357 of the said Act, is the joining of the efforts of two or more persons, called partners, for the purposes of carrying on a business. The terms and conditions for this association have to be specified in detail in the partnership agreement between the parties, which we can call "the beneficiary" (the small or medium-size enterprise) and "the investor/s/". The major objective of the agreement is to strictly regulate the specific rights and obligations of the parties. Investors could participate with cash or raw materials, non-consumable movables, real estate, consultancy or others. Where the interest is in the form of cash or consumable movables, they become the joint property of the partners in the proportion mentioned in the agreement. They shares are considered equal in the absence of such covenant. Where any of the parties has contributed non-consumable movables or real estate, such party retains title, transferring only the right to use the property under the terms and conditions of the joint venture agreement.

Everything acquired during the validity term of the agreement is considered to be the joint property of the partners in the agreed proportion. Earnings and losses are shared between the partners on a *pro rata* basis. It is not allowed to have only party participate in the earnings only and the other one to be solely responsible for losses. The termination of the partnership under the terms and conditions of the joint venture agreement leads to termination of the use of the other party's non-consumable property and to termination of the joint title to the cash or other consumable items. The co-ownership could be terminated in two ways. The first one is to apply agreed or court partition. The ways, in which the agreed partition is carried out, are specified in the joint venture agreement. Usually the partible property is divided fairly between the partners and some cash setting off is applied, if necessary. This is possible after the final termination of the joint business. If such voluntary liquidation of the joint property after termination of activities proves impossible for one or another reason, each partner has the right that cannot lapse in time to ask for partition in court. Thus the court can solve the problem with the distribution of the joint property, if some dispute arises between the partners in connection with their co-ownership. The first option in its two forms is very unlikely as a consequence of the winding up of the investment project envisioned in the joint venture agreement because the termination of the partnership should entail in any way winding up of the business of the undertaking that has received the investment.

Much more likely is the second option. It consists of a scheme, in which the beneficiary partner buys out the share of the other partner, the investor, where the beneficiary (as a result of the successful investment) is already capable of continuing the business on his own, refunding to the other party what was received under the joint venture agreement, together with the costs incurred and the possible damage suffered as a result of the operation of the partnership, as well as the agreed interest under the joint venture agreement. Thus an undertaking can be helped without direct lending. A joint investment project can be implemented in a rather simple way without the need for establishment of a joint venture. This is a way to avoid the requirements relevant to legal entities that are subject to registration in the court register at their place of establishment. This great advantage from the perspective of convenience and simplicity, however, has at least one substantial weakness, which is the relatively high risk for the investor and also the beneficiary because of the possibility for the costly and slow partition proceedings in case of dispute. Therefore this method of non-banking financing of enterprises, although quite common in our economic life, is not much opted for in the business practices of advanced countries, where preference is given to the third option for raising investment capital through an external investor in a limited liability company or a joint-stock company, which is either existing or established for this purpose.

Let us first examine the case, in which the investment project is implemented in the form of a limited liability company. This is most frequently an existing company (as stated earlier, the most common legal form for SMEs in Bulgaria is the limited liability company), willing to be assisted by a certain investor under the terms and conditions specified by the investor (business plan, production and marketing strategy over a certain period of time, expectations for future economic growth, etc.). After the project is approved by the investor, its implementation starts, while preserving the existing legal form of the undertaking, i.e. the limited liability company. For this purpose, a series of legal actions has to be undertaken in order to “legalize” the will of the investor and the beneficiary of the funds to implement the specific investment project. What are the steps to be taken one by one? In the first place, the limited liability company that will receive the investment has to increase its capital within the meaning of Art. 148, para 1, subpara 3 of the Commercial Code. This is increase of equity by admission of new partners. The investor has to join the company as a new partner. The admission procedure is exhaustively and imperatively covered in the Commercial Code. In pursuance of the provisions of Art. 122 of the Commercial

Code, the person willing to join a limited liability company has to serve a request in writing to the General Meeting, stating thereby his acceptance of all terms and conditions of the Memorandum of Association. The objective of this provision is to use the statement contained in the request and the possible admission of a new member as a way for the applicant to sign the Memorandum of Association, thus joining its on equal footing with the other partners. The request is a necessary but not sufficient condition for the admission. It is served and a General Meeting of the company is convened (most frequently as an extraordinary meeting) by the Managing Director of the company at his own initiative or at the initiative of partners holding at least one-tenth of the equity. In this particular case, the Managing Director would hardly refuse to convene the General Meeting, as its convention is undoubtedly in the interest of the company and its partners as "the owners" of the company that has acute shortage of financing. At least seven days prior to the date of the General Meeting each partner has to receive an invitation in writing with explicit mention of the draft agenda. This strict procedure for the convention of the General Meeting has to be observed in all cases because otherwise any decision made by the General Meeting may be attacked.

The agenda has to include at least the following items:

1. Examination of the request of the investor to join the company;
2. Voting on the admission of the applicant;
3. Adoption of the total amount of the investor's interest in the company;
4. Voting on the increase of the company's capital;
5. Voting on amendments to the Memorandum of Association.

The first two items on the agenda cover the examination of the investor's request to join the company by the existing partners and the admission of the applicant as a new partner in the company. The decision on the admission of a third party as a partner in the company requires the unanimous vote of all partners, which means that all of them have to be present at the General Meeting either in person or by proxy who is explicitly authorized with a Power of Attorney given in writing to another partner or a third party. After the investor is admitted as a new partner, it is necessary to calculate the amount of his share to be contributed to the property of the company. For this purpose, a balance sheet is drawn up as of the date of the General Meeting in order to specify the ratio between the equity of the company and its capital. The same ratio has to apply to the share to be contributed by the investor and used to increase the registered capital of the company. In other words, if the property of the company is twice big as its capital, the share of the new partner has to be twice bigger than his subscribed share, by which the capital has to be increased. So if the total investment is, say, BGL 100 mn, which is equal to the investor's share in the property of the company, the capital recorded in the commercial register will have to be increased by BGL 50 mn in order to keep the 2:1 ratio between the property and the capital of the company in our example. After the partners make the final decision on this matter, they have to put to the vote two more decisions, either separately or jointly: i.e. the decision on the increase of the capital by the amount described, and the decision on the amendments to the Memorandum of Association relative to the increased capital and the new partner who has subscribed a certain share in the corporate capital. Both decisions have to be taken by the General Meeting unanimously. This would not be a problem, once the partners have unanimously decided to admit the applicant to the company.

In order to become effective, these decisions have to be duly recorded in the Commercial Register. For this purpose, the Managing Director has to file a request to the Company Division of the Regional Court at the place of establishment of the company for adjustment of the entries concerning the company in the Commercial Register. It is required to attach a cover letter on the state fee paid under the state fee regulations and the receipt for the required amount paid for promulgation of the entries in The Official Gazette, as well as the minutes taken at the General Meeting on the decisions and voting results, the amendments to the Memorandum of Association, the invitations for the General Meeting sent out to the partners, and a bank certificate that the new partner has paid the amount, by which the capital of the company is increased and which represents his subscribed share in the capital, to the account with the designated bank. The promulgation of the entries in The Official Gazette is done by the court *ex officio* and has no legal incorporation effect with regard to the decisions of the General Meeting, which have entered into force. Obviously, the participation of the investor as a partner in a limited liability company that is willing to attract sufficient investments for its business purposes cannot be a goal in itself. It is true that, after his admission as a partner, the investor usually becomes the largest partner and in this capacity he would play a dominant role in the decision-making process but this is not the main point in this case. Because the goal here is not to acquire control but to invest against expected earnings from the investment. In other words, this method of providing the agreed financial resources is accompanied not only by the above legal procedure for acquisition of a share in the company that is the beneficiary of the investment in the context of the investment project, which is most often achieved through substantial increase of the capital by means of admitting a new partner, but also by a special agreement between the investor and the beneficiary of the investment. This agreement is not included in the Memorandum of Association of the limited liability company. It is not brought to the knowledge of the general public or the court of law, and it provided detailed description of the terms and conditions for repayment of the resources provided by the investor. The normal and permissible way of repaying the investment within the agreed time limits is through the re-purchase of the investor's share in the property of the company by the other partners in their capacity of "owners" of this property either upon the expiration of the investment project's term or at certain portions upon the expiration of some interim terms specified in the agreement. Thus the capital will not be increased any further and the amount of the shares of the individual partners in the property of the company will increase. It is most convenient to have the re-purchase done at the expense of the after-tax earnings accumulated in favour of the partners and duly distributed by the General Meeting. Instead of being used by the partners, these earnings can be used for the purpose of the re-purchase. Of course, it is perfectly possible for the partners not to be in a position to re-purchase the investor's share in the company because of failure to achieve the expected financial result. In this case, the investor will have to take the risk of preserving his share, and undertake the corporate management because of that, in order to try and help the company overcome its difficult financial condition and thus ensure the future re-purchase of the shares by the other partners. The Commercial Code allows for one more option specified in Art. 125, para 2. In pursuance of its provisions, the investor may terminate his participation by serving a notice in writing at least three months prior to the date of termination, the ownership consequences related to the payment of the share being settled on the basis of the balance sheet as of the end of the month of the termination. This option, however, that is associated with a rather quick withdrawal from an unfavourable situation, generates a number of problems of purely proprietary nature for the investor, which might be difficult to resolve (for example, would the other partners be in a position to pay the share and, if not, how the court of law can make them do so, etc.).

Let us assume that the situation develops favourably and see how the other partners will re-purchase the investor's share from the legal perspective. The procedure that we are going to examine is not generally affected by the fact whether the share will be re-purchased all at once or in portions or by the agreed ratio, in which each partner will purchase it. The transfer is free and no decision of the General Meeting is required to this effect. The transfer deal has to specify the amount of the share as part of the property of the limited liability company and the agreed price. The deal has to be made in writing and attested by the Notary Public. After the transfer, the agreement has to be recorded in the Commercial Register under the name of the company in order to enter into force with respect to third parties. This is the most common way, in which the investor will "walk out" of the company in need of funding for the investment project, and recover his investment. Of course, the investor may transfer the share to a third party designated by him rather than to the insolvent other partners (where they cannot afford to re-purchase the share). But in this case the consent of the other partners is required (and it is most unlikely to come), since this boils down to the admission of a third party as a partner; this is an option that we have already tackled in this paper.

Another opportunity for implementation of an investment project with the participation of a limited liability company is to incorporate such a "green-field" company with the participation of the small or medium-size enterprise (which may exist also in the legal form of a sole proprietor, corporate consortium, general or limited partnership) and the investor. The scheme would not radically differ from the previous one, except for the higher costs in this case because of the need for court registration of the limited liability company which will implement the investment project. The advantages of this option (notwithstanding the higher costs) consist mainly of the opportunity for starting "afresh", discussing and planning all the steps of the joint investment right from the outset, without the risks of an existing situation. All the stages of the project could be elaborated in the Memorandum of Association with sufficient guarantees for its observance by both parties. On the other hand, there is no obstacle for the clauses on the re-purchase of the share by the beneficiary of the financial assistance in the form of an investment in the newly established limited liability company to be negotiated in a separate agreement between the parties rather than in the Memorandum of Association. This option would be more successful in cases, where certain doubts exist as to whether such clauses in the Memorandum of Association would be an obstacle to the court registration of the company, as the local court of law might hesitate to enter such a "non-conventional" limited liability company in the Commercial Register. Generally speaking, such apprehensions that judges would be too suspicious are ill-grounded. Finally, there is one more substantial advantage of the suggested scheme for implementation of the joint investment project, which often makes it the only possible solution. It has been mentioned earlier that this is a very flexible scheme that makes it possible to finance not only limited liability companies (although they are the most common legal form of classical SMEs) but also sole proprietors (very widely spread practice), consortia (i.e. partnerships under Art. 357 *et seq.* of the Obligations and Contracts Act, which bring together individual parties for carrying on a business with specific delimitation of functions on the basis of a joint venture agreement without registration of a legal entity of any sort), or general or limited partnerships, which are typical associations of personalities, where the personal qualities of the partners rather than their contributions to the property are of decisive importance for the success of the business (as a matter of fact, these partnerships are not very common due to the substantial risk for the partners; still, we must mention that these partnerships, and especially the general partnership, are appropriate forms for a stable and relatively risk-free family business, while guaranteeing the equal respect for the interests of all participants).

We have pointed out earlier in this paper that the recipient or beneficiary of the financial resources needed for the business can also be a joint-stock company. Furthermore, the implementation of an investment project through this legal form is particularly well suited to the objectives of the project and therefore it is a very common practice in advanced economies (these are the investment projects with the use of venture capital). But we have made the point that the main shortcoming and obstacle to its wider spread in this country is the requirement for a minimum capital of BGL 50 mn under the Bulgarian laws. Thus the joint-stock company proved rather inappropriate for small and even medium-size enterprises. At the same time, the venture capital system can be successfully applied to cases, where a joint-stock company is registered for the purposes of the investment project, as this legal form offers greater advantages from the perspective of the investment objectives.

Let us examine the main advantages in the use of joint-stock companies as the legal form for investment financing as compared to the limited liability company. In our opinion, they can be put in two major groups: one, advantages associated with the admission of new members (shareholders) and the further transfer of their shares; and, two, advantages associated with the corporate governance which facilitate the attainment of the expected positive financial results. At the same time, we must point out an important shortcoming of this model, i.e. the court fees and the other registration costs are higher than the costs of limited liability companies. But as long as they are usually incurred by the investor, this would hardly stand as a barrier to the successful implementation of the investment project.

What are the main stages of the financial support project, which have to be regulated in detail in the agreement between the beneficiary and the investor, serving as the legal groundwork for the implementation of the investment project? Probably the best and simplest solution is for the beneficiary, who is registered in the Commercial Register as a limited liability company, to undertake the necessary action for the admission of the investor as a partner in the company. We have already examined the sequence of actions and, as a result, the investor is admitted as a partner against the contribution of the investment to the property of the company. The next stage entails the conversion of the limited liability company into a joint-stock company in pursuance of the provisions of Art. 262 of the Commercial Code. In the first place, the General Meeting has to make a decision on the conversion into a joint-stock company by a majority of two-thirds of the corporate capital. This should not be a problem because it has already been specified in the investment agreement. For the sake of greater convenience and expediency, this decision may be made at the same General Meeting, at which the capital is increased and the investor is admitted as a new partner. Thus the General Meeting of the partners in the limited liability company will be transformed into a Constituent Meeting of the new joint-stock company. It will be attended by the partners in the beneficiary company together with the newly admitted partner, i.e. the investor. The Constituent Meeting of the new joint-stock company is to be held in pursuance of the provisions of Art. 169 of the Commercial Code. The single most important decision of the

Constituent Meeting is to incorporate a joint-stock company in its capacity of universal successor to the terminated limited liability company as from the time of the latter's termination. Besides, all necessary incorporation documents have to be adopted and the legal actions listed in Art. 170, para 1 of the Commercial Code have to be undertaken (adoption of Articles of Association of the joint-stock company, ascertaining that the capital of the converted company is ate least BGL 50 mn, replacement of the equity shares in the former limited liability company by shares in the joint-stock company and issuance of provisional certificates thereof, election of a Board of Directors /where the beneficiary and the investor have agreed on a one-tier system of corporate governance/ or a Supervisory Board that has to appoint the Managing Board /where the parties have agreed to establish a two-tier system of corporate governance, where the investor is normally represented in the Supervisory Board/ etc.). After the end of this extremely important last General Meeting of the limited liability company, which has turned into a Constituent Meeting of the new joint-stock company as its legal successor, the new management bodies submit the documents required for the registration of the joint-stock company, together with the request for conversion, to the regional Court at the place of registration of the limited liability company. The date of the entry on the conversion in the Commercial Register is deemed to be the end of the limited liability company and the beginning of the joint-stock company, which already has broader opportunities for business development. The replacement of the Managing Director of the limited liability company by a collective managing body, depending on the new legal form of the existing undertaking (Board of Directors or Managing Board), creates conditions for more substantial direct participation of the investor in the corporate activities, which, together with the financing, is of great benefit to the enterprise. Thus the investor is in a position to precisely and continuously follow business operations and, if necessary, undertake adequate measures to overcome shortfalls. On the other hand, the joint-stock company as a legal form provided opportunities for much simpler recovery of the investment and "walk-out" of the company after the end of the investment project. The investor is a shareholder like all the rest and hence there exist no legal problems concerning the sale of the corporate shares to other parties. These other parties may be the other shareholders (the former partners in the limited liability company implementing the investment agreement signed in the beginning) or third parties. Registered shares are transferred through endorsement (ordinary entry of the transfer on the back side of the share or the provisional certificate) followed by entry into the Book of Shareholders. Where the other shareholders would not like to have the investor transfer his shares to third parties who are unfamiliar to them, they might insist on a right of fist option to be included in the Articles of Association at the Constituent Meeting. This means that the transfer will be legally valid only if shares are first offered to the existing shareholders and, upon the refusal to purchase them, they are offered to third parties. But if the other shareholders are not interested, it is perfectly possible to find another strategic investor who will purchase the shares. We should not underestimate also the opportunity for public placement of shares with individual or institutional investors on the capital market. But, for this purpose, a prospectus has to be prepared for the public placement in accordance with the requirements of the Securities Act. This will make the joint-stock company public within the meaning of the said Act. In the final analysis, the major goal is to create appropriate conditions for further economic growth and prosperity of the small or medium-size enterprise, which will bring to successful completion the investment project as the most widely spread source of non-banking financing of business in international business practices.